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SUBJECT: TOKYO STOCK EXCHANGE PRESIDENT DISCUSSES JAPAN'S
EXPERIENCE IN FINANCIAL SECTOR RESTRUCTURING WITH A/S
SULLIVAN

TOKYO 00003151 001.2 OF 002

¶1. (SBU) Summary: Japan's experience resolving its 1990-2002 financial crisis demonstrates direct re-capitalization of banks is the most effective way to revive a weakened financial sector, Tokyo Stock Exchange (TSE) President Atsushi Saito told visiting EEB Assistant Secretary Sullivan November 5. Saito commended recent efforts by the U.S. Treasury to use USD 250 billion from the Emergency Economic Stabilization Act of 2008 to inject capital directly into bank balance sheets. End summary.

¶2. (SBU) Saito noted he headed the Industrial Revitalization Corporation of Japan (IRCJ) from 2001-2006, when the quasi-public entity was responsibile for restructuring Japan's bankrupt industrial firms and stabilizing their weakened lenders. Although IRCJ had a government allocation of 10 trillion yen (approximately $100 billion at current exchange rates) and explicit government guarantee of its debt, it was able to finance its five-year operations entirely with capital raised in short-term money markets, Saito said. The corporation never drew on its government allocation and eventually passed approximately 7 billion yen back to the national treasury. Private sector financing was made easier by Japan's historically low interest rates at that time.

¶3. (SBU) The IRCJ's biggest challenge was insisting on honest accounting and appropriate valuation of assets, Saito told the visiting Assistant Secretary. Many bankers at that time, Saito continued, were encouraging borrowers to hold assets on their books at face value and kept lending to insolvent borrowers. Bankers feared if assets were marked to markeQ the banks would be subject to shareholder lawsuits and public criticisQHoweQ, this continued denial of reality only prolonged the crisis and put the banks' own balance sheets at risk.

¶4. (SBU) The IRCJ insisted insolvent corporations "face reality in analyzing their balance sheets", Saito explained. Where market valuations were possible, IRCJ marked assets to market. Where independent valuation was unavailable, IRCJ made a best faith estimate of the asset's value based on underlying cash flow. At the same time, IRCJ insisted shareholders and corporate executive take personal and financial responsibility for their past business decisions.

In almost all cases write-downs wiped out shareholder equity while IRCJ managers forced the bankrupt companies' executives to give up salaries, bonuses, and pensions. In one case, a former hotel company president was asked to become the company's bus driver. While that example was dramatic, Saito's point was holding executives accountable was a political necessity.

¶5. (SBU) At the same time, Saito said, he spent considerable time speaking to journalists and other opinion makers to convince them IRCJ was not "bailing out irresponsible corporations" but rather working in the interests of taxpayers. By insisting on "haircuts" before restructuring corporations and recapitalizing banks, he largely succeeded in muting Japanese public criticism of IRCJ,s work.

¶6. (SBU) Saito strongly urged the U.S. to continue to focus on direct capital injections into the banking system. The Japanese government has had to recapitalize the banking system three times in the postwar period, and each time the move has convinced investors that the market had bottomed out and restored private sector confidence. The alternative strategy of government purchases of distressed assets through public auction carried risks of unintended consequences for the prices of unrelated assets. Since rating agencies would be forced to use the auction price as a reference for pricing other non-markets assets held by banks or other financial institutions, a low auction price could negatively affect the balance sheets of many other companies.

¶7. (SBU) Although direct capital injections can be politically controversial, Saito acknowledged, regulators and government officials can convince taxpayers of the steps' merits if regulators insist on corporate executive

responsibility for past failures. Taxpayers can even profit. For example, the Bank of Japan intervened in financial markets in the late 1990's by directly purchasing bank stock and, eventually, the BOJ "made huge profits", Saito explained.

¶8. (SBU) In the long run, Saito concluded, it is critical for governments to reiterate as strongly as possible the core role of markets in the economy. "State capitalism was the disease of the past 100 years," Saito emphasized. "And, while everyone recognizes regulators and other market players made mistakes in managing aspects of the financial system, these mistakes do not undermine the importance of the market as the best guarantee of long-term economic growth and prosperity."

¶9. (U) This message was cleared by A/S Sullivan subsequent to his departure from Tokyo.
SCHIEFFER